IT 01-18
Tax Type: Income Tax
Issue: Research & Development Credit
Business/Non-Business (General)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS,	No. 00-IT-0000 FEIN 00-0000000
v.	Tax Yrs. 1993, 1994, 1995
"PUFFNSTUFF, INC.", **Taxpayer**	**Ted Sherrod** **Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorneys General Ralph Bassett and Ron Forman on behalf of the Illinois Department of Revenue; Mark Eidman, Esq. and Ray Lagenberg, Esq. of Scott, Douglass & McConnico, on behalf of "Puffnstuff, Inc."

Synopsis:

The Illinois Department of Revenue ("Department") issued Notices of Deficiency ("NODs") to "Puffnstuff, Inc." (hereinafter "Puffnstuff" or "taxpayer") which proposed to assess additional Illinois income taxes for tax year 1993. The Department also issued Notices of Denial regarding amended income tax returns filed by the taxpayer for tax years 1994 and 1995. "Puffnstuff" protested these NODs and Notices of Denial and requested a hearing. Pursuant to a prehearing order, the parties identified the issues to be resolved at the hearing as follows: 1) whether the taxpayer's gain from the sale of its

minority interest in "Mendota Technologies, Inc." in 1993 was business income under 35 **ILCS** 5/1501(a)(1) (hereinafter the "Business Income Issue"); 2) whether the taxpayer's gain from this sale was taxable by Illinois under the Due Process Clause and the Commerce Clause of the U.S. Constitution (hereinafter the "Due Process and Commerce Clause Issue"); 3) whether the taxpayer was entitled to the disallowed research and development credits for the tax years ending 12/31/93 and 12/31/94 (hereinafter the "Research and Development Credit Issue"); and 4) whether the taxpayer was entitled to a capital loss carry back for the tax year ending 12/31/95 that originated in the tax year ending 12/31/97.

A hearing on this matter was held on June 5, 2001. The taxpayer's senior tax counsel, Mr. "Daryll Duke", testified at the hearing. Certain of "Puffnstuff's" books and records were also produced into evidence. During the hearing the parties stipulated that the taxpayer is entitled to a capital loss carryback for the tax year ending 12/31/95 that originated in the tax year ending 12/31/97. Moreover, the Department has conceded that the taxpayer is entitled to a portion of the research and development credits for 1993 and 1994 that were previously disallowed. Department Brief p. 27. In light of the foregoing, and after a review of the record in this case, I recommend that the NODs issued for 1993 and the Notices of Denial issued for 1994 and 1995 be modified: 1) to cancel the assessment on the taxpayer's capital gain; 2) to allow a research and development credit for research and development expenditures related to the taxpayer's Groton Connecticut facility, and 3) to allow a capital loss carryback for the tax year ending 12/31/95 that originated in the tax year ending 12/31/97 and, as so adjusted, be made final.

Findings of Fact:

Facts Regarding Issues 1 and 2, the Business Income Issue and the Due Process and Commerce Clause Issue.

1. The Department's *prima facie* case, inclusive of all jurisdictional elements, was established by the admission into evidence of the Notice of Deficiency dated January 26, 1999 regarding the taxpayer's tax year ending 12/31/93, the Notice of Deficiency dated October 20, 1999 regarding the taxpayer's tax year ending 12/31/93, the Notice of Denial dated October 20, 1999 regarding the taxpayer's tax year ending 12/31/94, and the Notice of Denial dated November 30, 1999 regarding the taxpayer's tax year ending 12/31/95. [1]
2. The taxpayer is a corporation, incorporated under the laws of Delaware, with its principal place of business in New York City, New York. Stip. Ex. 20, 22.
3. The taxpayer is a research-based, global health care company. Stip. Ex. 18.
4. At the beginning of 1992 the taxpayer had four business segments: i) health care (proprietary pharmaceuticals and medical devices), ii) consumer products (non - prescriptive health care products, cosmetics and fragrances), iii) animal health and iv) specialty chemicals and minerals (ingredients for food and beverage industries, and mineral -based products for industrial use). Stipulation ¶ 12.
5. Prior to September, 1992, the taxpayer's specialty minerals business consisted of physical assets, intellectual property, human resources and first and second tier subsidiaries identified in the taxpayer's Reorganization Agreement with "Mendota

[1] Unless otherwise noted, findings of fact apply to the tax periods in controversy.

Technologies Inc." (“"MTI"”) dated September 28, 1992, and in the ""MTI"" prospectus dated October 23, 1992. Stip. ¶ 13; Stip. Ex. 20, 22.

6. The taxpayer’s specialty minerals business had research facilities in (City #1), Pennsylvania and (City #2), Pennsylvania; these research facilities were separate and independent from the taxpayer’s other research facilities both before and after "Puffnstuff’s" divestiture of ""MTI"", and there was no coordination between these research facilities and the taxpayer’s other research facilities. Stip. ¶ 14.
7. There was no exchange of research and development between the taxpayer’s specialty minerals business and ""MTI"", or the taxpayer’s other businesses either before or after the taxpayer’s divestiture of "MTI". Stip. Ex. 24 (hereinafter “Dep. of ""Jean-Paul Sartre""”), p. 8.
8. The taxpayer’s specialty minerals business was engaged in the development, production and marketing of a broad range of specialty mineral, mineral-based and synthetic mineral products; these products were used in manufacturing processes of the paper and steel industries, as well as by the building materials, polymers, ceramics, paints and coatings, glass and other manufacturing industries. Stip. ¶ 15; Stip. Ex. 22.
9. The taxpayer’s specialty minerals business was the leading producer and supplier to the North American paper industry of Precipitated Calcium Carbonate (“PCC”), a synthetic form of mineral calcite used by paper producers in the akaline papermaking process to enhance the brightness and opacity properties of paper. Stip. Ex. 22.

10. In 1986, the taxpayer's specialty minerals business introduced the first commercial satellite PCC plant, a modular unit constructed by the company on the site of a "host" paper mill facility. Dep. of ""Jean-Paul Sartre"", p. 12; Stip. Ex. 22.
11. By the end of 1991, 21 paper mills in the United States and Canada had PCC on-site plants; none of these on-site plants were located in Illinois. Stip. ¶ 16.
12. The taxpayer's specialty minerals business had manufacturing facilities located in Massachusetts, Montana, Pennsylvania, California, Connecticut; the business had no manufacturing facilities that were located in Illinois. Stip. ¶ 16.
13. PCC was one of the taxpayer's three major product lines; the other two major product lines were mineral based refractory materials used to resist the effects of high temperature which was applied to surfaces exposed to extreme heat, and natural-based products including limestone, talc, calcium, and metallurgical wire products. Stip. ¶ 17.
14. Prior to October 23, 1992, the taxpayer decided to divest its specialty minerals business in order to focus on its core health care business. Stip. ¶ 18.
15. "Mendota Technologies, Inc." (""MTI"") is a Delaware corporation with its principal executive offices in New York City, New York". Stip. Ex. 22.
16. ""Jean-Paul Sartre"" is the Chairman of the Board and Chief Executive Officer of "MTI", and served as chief executive officer of the predecessor of "MTI", "APM" group, which was composed of a subsidiary and a division of "Puffnstuff", from 1989 until 1992. Dep. of "Jean-Paul Sartre"", p. 5.
17. Prior to the divestiture of "MTI", the taxpayer was the sole shareholder of "MTI". Stip. ¶ 19; Stip. Ex. 20.

18. On or about September 28, 1992 taxpayer and "MTI" entered into a written Reorganization Agreement (“Agreement”); pursuant to this agreement, the taxpayer transferred to "MTI" all its right, title, and interest in the issued and outstanding stock of "Bologna Minerals Inc.", "Sonora Minerals Inc." and "System Refractories Inc.", "Puffnstuff MSP KK", "Quonset Company Europe Ltd.", and "Quonset Magnesium Ltd." Stip. ¶ 21.
19. Pursuant to the Agreement, "Puffnstuff Ltd.", a subsidiary of the taxpayer, sold to "MTI" the stock of "Puffnstuff Sonora Minerals, UK Ltd." Stip. ¶ 21.
20. Pursuant to the Agreement, "Puffnstuff S.A.", a French company and subsidiary of the taxpayer, sold to "MTI" all of its assets. Stip. ¶ 21.
21. The taxpayer transferred to "MTI" all of the taxpayer’s right, title and interest in its U.S. and foreign patents, registered trademarks, registered trade names, registered copyrights, and application and goodwill associated with its transfer of subsidiaries and assets pursuant to the Agreement. Stip. ¶ 21.
22. Subsidiaries whose stock was contributed to "MTI" pursuant to the Agreement owned assets consisting of PCC on-site plants, offices, research facilities, and warehouses. In addition, they owned vacant land, talc, limestone and iron ore mines and mineral reserves. Stip. ¶ 21.
23. None of the assets, real estate, office leases, patents, research facilities and production facilities transferred by the taxpayer to "MTI" pursuant to the Agreement were located in Illinois. Stip. ¶ 21.

24. The taxpayer transferred all of its assets related to the specialty chemicals business into a single group that became part of "MTI" prior to the "MTI" divestiture. Dep. of ""Jean-Paul Sartre"", pp. 19, 20.

25. Prior to the divestiture of "MTI", the specialty chemicals business plants and other assets were separate and independent from the taxpayer's other plants and assets. Dep. of ""Jean-Paul Sartre"", p. 21.

26. The taxpayer's specialty chemicals business and "MTI" shared a headquarters building with the taxpayer both before and after the divestiture. Dep. of ""Jean-Paul Sartre"", p. 21.

27. On October 22, 1992 the taxpayer's Board of Directors decided that it would be in the best interest of the taxpayer to sell a majority of its shares of common stock of "MTI" in an initial public offering ("IPO"). Stip. ¶ 22; Stip. Ex. 21.

28. The taxpayer sold sixty (60) percent of its interest in "MTI" in an initial public offering on October 23, 1992. Stip. ¶ 24; Stip. Ex. 22.

29. Following the initial public offering on October 23, 1992, "MTI" stock was publicly traded on the New York Stock Exchange under the symbol "AAA". Stip. ¶ 23.

30. The taxpayer filed an Illinois Corporation Income and Replacement Tax Return, IL-1120 for 1992, which was amended on October 16, 1996 and again on May 10, 2000; the return and amended returns reported the income from the specialty minerals business prior to its reorganization and reported the gain from the sale of approximately sixty (60) percent of the taxpayer's stock in "MTI" as business income and as income from the taxpayer's unitary business group. Stip. ¶ 25; Stip. Ex. 15.

31. On February 25, 1993, the taxpayer's Board of Directors resolved to sell the taxpayer's remaining 40% interest in "MTI", consisting of 10,050,000 shares of common stock, with 7,550,000 shares to be sold through a registered secondary offering, and 2.5 million shares to be sold directly to "MTI"; the taxpayer sold its remaining approximately 40% interest in "MTI" on April 6, 1993. Stip.¶ 26, 27; Stip. Ex. 18, 23.
32. The taxpayer entered the specialty chemicals business to reduce the risk of relying exclusively on its pharmaceutical and health care businesses. Dep. Of ""Jean-Paul Sartre"", p. 7.
33. The taxpayer sold no products to "MTI" and "MTI's" sales of products to the taxpayer were de minimis. Dep. of ""Jean-Paul Sartre"", p. 21.
34. Transfers of employees between "Puffnstuff's" specialty chemicals business and "Puffnstuff's" other businesses were de minimis. Dep. of ""Jean-Paul Sartre"", p. 23.
35. "Puffnstuff" was not involved in the day to day management or decision-making processes of "MTI" after the initial public offering. Dep. of "Jean-Paul Sartre", pp. 44, 45, 46, 47, 48.
36. "MTI's" cash management operation was completely separate from the taxpayer's after the initial public offering of "MTI" stock in October, 1992; after this date there were no transfers of excess cash between "MTI" and the taxpayer. Dep. of "Jean-Paul Sartre", p. 26.
37. The taxpayer played no role in financing the operations of "MTI" after the initial public offering in October, 1992. Dep. of "Jean-Paul Sartre", p. 27.

38. The taxpayer and "MTI" entered into a Transitional Services Agreement in connection with the taxpayer's divestiture of its specialty chemicals business in 1992; pursuant to this agreement the taxpayer agreed to make available to "MTI" certain services including accounts payable, accounts receivable, credit and collections, payroll implementation, corporate information systems, telephone and computer services and use of space and office services at the taxpayer's headquarters; these services were made available for a transitional period of up to one year from the close of the IPO. Stip. Ex. 22.
39. Pursuant to the Transitional Services Agreement, "MTI" could terminate services at will when it determined they were no longer needed. Dep. of "Jean-Paul Sartre", p. 37.
40. The taxpayer provided payroll processing services to "MTI" after the initial public offering in October, 1992 pursuant to the Transitional Service Agreement; the taxpayer was compensated for the provision of these services at cost. Dep. of "Jean-Paul Sartre", pp. 31, 37; Stip. Ex. 22.
41. The taxpayer advanced funds to "MTI" employees as part of its payroll processing service and was reimbursed for these advances by "MTI". Dep. of "Jean-Paul Sartre", p. 31.
42. The taxpayer did not provide legal, environmental or tax services to "MTI" after the initial public offering of "MTI" stock. Dep. of "Jean-Paul Sartre", p. 32.
43. The taxpayer provided computer and data processing services to "MTI" after the initial public offering in October, 1992 pursuant to the Transitional Services

Agreement; the taxpayer was compensated for the provision of these services at cost. Dep. of "Jean-Paul Sartre", p. 33, 37; Stip. Ex. 22.

44. "MTI" rented office space from the taxpayer until September, 1993 pursuant to the Transitional Services Agreement; the taxpayer was compensated for the provision of office space at cost. Dep. of "Jean-Paul Sartre", pp. 33, 37; Stip. Ex. 22.

45. The specialty chemicals business and "MTI" had their own finance operation both prior to and after the initial public offering. Dep. of "Jean-Paul Sartre", p. 35.

46. The specialty chemicals business and "MTI" marketing and advertising operations were independent from the taxpayer's marketing and advertising prior to and after the initial public offering. Dep. of "Jean-Paul Sartre", pp. 35, 36.

47. With the exception of the taxpayer's 401(k) benefits, "MTI's" employees were not covered by the taxpayer's insurance or benefit plans after the initial public offering. Dep. of "Jean-Paul Sartre", pp. 38, 39.

48. "MTI" reimbursed the taxpayer for 401(k) benefits it provided to "MTI" employees after the initial public offering. Dep. of "Jean-Paul Sartre", p. 39.

49. "MTI" received services and benefit plan assistance only where it could not outsource these functions to independent third parties by the date of the initial public offering for administrative reasons; it received these services only until it could outsource them to third parties or bring them in house. Dep. of "Jean-Paul Sartre", pp. 39, 40, 41.

50. "MTI" ceased to use the "Puffnstuff" name and logo or otherwise identify itself as being part of "Puffnstuff" after the initial public offering in October, 1992. Dep. of "Jean-Paul Sartre", p. 43.

51. "MTI" management ceased to formally report to "Puffnstuff" management and provided no information regarding any financial transactions to the taxpayer after the initial public offering. Dep. of "Jean-Paul Sartre", pp. 45, 46, 47.
52. "MTI" management was not required to obtain "Puffnstuff" management's approval before making expenditures after the initial public offering. Dep. of "Jean-Paul Sartre", p. 46.
53. The taxpayer had no input into the management of "MTI" and no authority to approve or disapprove "MTI's" management decisions. Dep. of "Jean-Paul Sartre", pp. 48, 52, 53.
54. "MTI"'s chairman was not required to obtain the approval of the taxpayer's management for any management decisions. Dep. of "Jean-Paul Sartre", p. 53.
55. "Remington Steele", the taxpayer's chief executive officer and "Jack Sprat", the chairman of the taxpayer's Board of Directors, served as members of "MTI"'s board between October, 1992 and April, 1993. Dep. of "Jean-Paul Sartre", pp. 53, 54.
56. "Jean-Paul Sartre" remained a member of the taxpayer's Board of Directors after the initial public offering. Dep. of "Jean-Paul Sartre", p. 54.
57. The taxpayer was the largest shareholder of "MTI" after the initial public offering ("IPO") until the sale of its 40 percent interest in the company. Dep. of "Jean-Paul Sartre", p. 52.
58. "MTI's" Board of Directors consisted of seven members. Dep. of "Jean-Paul Sartre", p. 55.
59. "MTI's" board met several times between October, 1992 and April, 1993. Dep. of "Jean-Paul Sartre", pp. 86, 87.

60. With the exception of "Remington Steele", "Jack Sprat" and "Jean-Paul Sartre", none of the other "MTI" board members were ever affiliated with "Puffnstuff" as officers, employees or board members. Dep. of "Jean-Paul Sartre", pp. 54, 55.

61. There was no communication between "MTI's" management and the taxpayer's management between October, 1992 and April, 1993; the only discussion of "MTI's" business with members of the taxpayer's management occurred during "MTI" board meetings attended by "Puffnstuff" officers that were "MTI" board members. Dep. of "Jean-Paul Sartre", p. 87.

62. The taxpayer forgave all "MTI" debt to the taxpayer at the time of the initial public offering; as a result "MTI" started with no debt on its balance sheet. Dep. of "Jean-Paul Sartre", p. 56.

63. "MTI" borrowed money to repurchase 10% of "MTI's" stock from the taxpayer at the time of the secondary offering of "MTI" stock in April, 1993; this financing was undertaken without the assistance, involvement or approval of the taxpayer. Dep. of "Jean-Paul Sartre", p. 57

64. At the time of the secondary offering in 1993, "MTI" repurchased its stock at less than the market price by arranging to repurchase stock directly from the taxpayer; the price paid for its stock was $24 which was $1 less than the market price, with the price difference resulting from the avoidance of commissions normally paid to syndicate brokers on stock purchases. Dep. of "Jean-Paul Sartre", pp. 58, 59.

65. The taxpayer sold its specialty chemicals business in order to concentrate on its core pharmaceutical and health care businesses; this decision was also based on the poor

performance of the taxpayer's refractory operations, a component of its specialty chemicals business. Dep. of "Jean-Paul Sartre", pp. 60, 85.

66. The disposition of the specialty chemicals business was undertaken as part of a plan to dispose of all non-core businesses unrelated to the taxpayer's health care business. Dep. of "Jean-Paul Sartre", pp. 61, 62.

67. The taxpayer intended to sell 100% of its stock in "MTI" as part of its initial public offering; it decided to sell only 60% after being advised by a syndicate of investment bankers that selling all of "MTI's" stock in an initial public offering was not possible. Dep. of "Jean-Paul Sartre", pp. 62, 63, 64, 65, 72, 77.

68. The timing of the secondary public offering was the result of an increase in the "MTI" stock price and other favorable market conditions. Dep. of "Jean-Paul Sartre", pp. 65, 66, 67, 68, 69.

Facts Regarding Issue 3, the Research and Development Credit Issue.

69. Taxpayer is engaged in extensive research and development activities. Tr. pp. 9, 14; Stip. Ex. 17, 18.

70. The taxpayer operates research and development ("R&D") facilities both within and outside of the United States; the taxpayer's R&D headquarters is located in Connecticut and its other U.S. R&D facilities are in Indiana and New York. Stip. Ex. 17.

71. Taxpayer filed Illinois State income tax returns for 1993 and 1994 claiming research and development credits on Schedules 1299-D. Tr. p. 15; Stip. Ex. 25, 26.

72. The Department issued a Notice of Deficiency denying the R&D credit claimed by the taxpayer for 1993 on October 20, 1999; the taxpayer subsequently filed a protest contesting the denial of this credit on December 14, 1999. Stip. Ex. 3, 4.

73. On January 26, 1999, the Department issued a Notice of Overassessment for TYE 12/31/94 and 12/31/95 allowing the taxpayer's R&D credit for TYE 12/31/94. Stip. Ex. 5, 7.

74. The taxpayer filed an IL 1120-X claiming the R&D credit in accordance with the Notice of Overassessment on March 23, 1999. Stip. Ex. 6.

75. On October 20, 1999 the Department advised the taxpayer that the R&D credit for 1994 was incorrectly allowed in the audit results and denied the taxpayer's claim for refund of overpaid taxes based on the allowance of an R&D credit as indicated in the Notice of Overassessment. Stip. Ex. 7.

76. The taxpayer's Illinois R&D credit was tied to expenses reported as "qualifying expenses" eligible for the Federal R&D credit under Sec. 41 of the Internal Revenue Code ("IRC") on the taxpayer's federal income tax return; the Internal Revenue Service ("IRS") audited the federal income tax R&D credits claimed by the taxpayer and made no amendments to the federal income tax credits the taxpayer claimed. Tr. pp. 15, 16, 17; Stip. Ex. 27, 28, 33, 34.

77. The taxpayer incurred expenses for R&D performed under contract by doctors and other health care professionals, and by hospitals and other institutions in Illinois and other states; these expenses were incurred by the taxpayer's Connecticut facility and by its U.S. Pharmaceuticals Group. Tr. pp. 16, 17, 18, 19, 20.

78. A schedule of R&D expenditures ("R&D schedule") broken down by state shows R&D expenses the taxpayer claims were incurred by the taxpayer's Connecticut facility and its U.S. Pharmaceuticals Group in 1993 and 1994; these expenses were reported as expenses qualifying for the R&D credit allowed by Sec. 41 of the IRC on the taxpayer's federal income tax returns. Tr. p. 17; Stip. Ex. 31.

79. The taxpayer's R&D schedule for its Connecticut facility for 1993 and 1994 was prepared from the taxpayer's accounting detail used to prepare accounts 2180 and 2190 contained in the taxpayer's accounts payable ledger; this detail shows vendor numbers, invoice numbers, vendor names, the numbers of checks disbursed to vendors, the dates of payment and the amounts invoiced. Tr. pp. 19, 20, 21; Stip. Ex. 29, 30, 31.

80. Taxpayer's expenditures for R&D in 1990, 1991 and 1992, used in compiling the taxpayer's Connecticut facility Illinois R&D credit for 1993 and 1994 were also prepared from accounts payable detail used to prepare accounts contained in the taxpayer's ledger. Tr. p. 22; Stip. Ex. 32.

81. The R&D schedule shows R&D expenditures broken down by state that were incurred by the taxpayer's U.S. Pharmaceuticals Group; these expenditures cannot be directly tied to accounts payable detail used to prepare any of the taxpayer's general ledger accounts in 1994 because this detail could not be located by the taxpayer. Tr. p. 21; Stip. Ex. 31.

Conclusions of Law:

Business Income Issue

The issue to be determined is whether the capital gain realized by the taxpayer when it sold 40 percent of the stock of "MTI" constituted business income apportionable to Illinois. The taxpayer contends that it properly reported this gain as non-business income on its state income tax return for the tax year ending December 31, 1993.

Section 1501(a)(1) of the Illinois Income Tax Act ("IITA"), 35 **ILCS** 5/1501(a)(1), (hereinafter "section 1501(a)(1)") defines "business income" as being "income arising from transactions and activity in the regular course of the taxpayer's trade or business … and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations". Section 1501(a)(13) of the IITA, 35 **ILCS** 5/1501(a)(13), defines "non-business income" as being "all income other than business income or compensation."

A taxpayer's income is business income unless the income is clearly non-business income. 86 Ill. Admin. Code § 100.3010(a), 35 **ILCS** 5/1501(a)(13). Pursuant to section 904 of the IITA, the Department established the *prima facie* correctness of its determination that the items of income were business income when it introduced the NOD for 1993 and the Notice of Denial for 1994 into evidence at the hearing. Stip. Ex. 1, 7; 35 **ILCS** 5/904. The burden of proof is on the taxpayer to prove that the income in question is non-business income. Kroger Company v. Department of Revenue, 284 Ill. App. 3d 473, 479 (1st Dist. 1996).

The statute provides for two tests to determine if income is business income. The tests are described as the transactional test and the functional test. If the income satisfies

either test, it is business income. Dover Corporation v. Department of Revenue, 271 Ill. App. 3d 700, 711 (1st Dist. 1995). The transactional test, which is derived from the first clause of section 1501(a)(1), classifies income as business income if the income is derived from a type of transaction the taxpayer normally conducts in its enterprise. The functional test is derived from the second clause of section 1501(a)(1), and classifies income as business income if the property disposed of constituted an integral part of the taxpayer's business operations.

The record indicates that the transactional test has not been satisfied in this case. It clearly supports the taxpayer's claim that the sale of its interest in "MTI" was not the type of transaction the taxpayer normally conducts in its business. While the taxpayer made several dispositions of divisions and subsidiaries between 1992 and 1999, (Dep. of "Jean-Paul Sartre", pp. 62, 63), there is no evidence in the record showing that the taxpayer was in the regular business of buying, holding or selling the stock of other corporations. The taxpayer's disposition of the stock in "MTI" and other companies was simply a consequence of its divestiture of activities unrelated to its core health-care business. Dep. of "Jean-Paul Sartre", pp. 61, 62. These dispositions were clearly extraordinary transactions that were not undertaken with the systematic regularity characterizing normal trade or business operations. Rather these sales were part of a once-in-a–corporate-lifetime restructuring designed to refocus the taxpayer's operations on its core business. Dep. of "Jean-Paul Sartre", pp. 61, 62. Specifically, a review of the taxpayer's 1992 and 1993 Annual Reports indicates that the taxpayer sold only two businesses in 1992, and that its only divestiture in 1993 was its sale of its 40% interest in "MTI". The record also indicates that the initial public offering of "MTI" stock in 1992

was the only spin off in the history of the company. Tr. p. 10; Dep. of "Jean-Paul Sartre", p. 60. Moreover, the Department of Revenue has implicitly admitted that the gain realized by the taxpayer on its sale of "MTI" was not business income under the transactional test by contending that the gain from the taxpayer's sale of its interest in "MTI" constituted business income under only the functional test. Tr. p. 7; Dept. Brief pp. 9 – 14.

The functional test, which the Department contends has been met in this case, is drawn from the second clause of section 1501(a)(1) ("income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations"). Under the functional test, the relevant inquiry is whether the property was used in the taxpayer's regular trade or business operations. Texaco-Cities Service Pipeline Co. V. McGaw, 182 Ill. 2d 262, 269 (1998) ("More broadly, under the functional test, all gain from the disposition of a capital asset is considered business income if the asset disposed of was 'used by the taxpayer in its regular trade or business operations' ").

The application of the functional test is illustrated by the Department's income tax regulation entitled "Business and non-business income", 86 Ill. Admin. Code § 100.3010. This regulation provides in pertinent part as follows:

> (d) Items referred to in IITA Section 303 and unspecified items under IITA Section 301(c)(2).
>
> (1) In general … Any item may, in a given case, constitute either business income or non-business income depending on all the facts and circumstances. The following are rules and examples for determining whether particular income is business or non-business income. (The examples used throughout these regulations are illustrative only and do not purport to set forth all pertinent facts.)
>
> ****

(5) Dividends. Dividends are business income where the stock with respect to which the dividends are received, is held or was acquired in the regular course of the person's trade or business operations or where the purpose for acquiring or holding the stock is related or attendant to such trade or business operations.

(A) Example A: A corporation operates a multi-state chain of stock brokerage houses. During the year the corporation receives dividends on stock it owns. The dividends are business income.

(B) Example B: A corporation is engaged in a mult-istate manufacturing and wholesaling business. In connection with the business the corporation maintains special accounts to cover such items as workmen's compensation claims, etc. A portion of the moneys in those accounts is invested in interest bearing bonds. The remainder is invested in various common stocks listed on national stock exchanges. Both the interest income and any dividends are business income.

(C) Example C: Several unrelated corporations own all of the stock of another corporation whose business operations consist solely of acquiring and processing materials for delivery to the corporate owners of its stock. The corporations acquired the stock in order to obtain a source of supply of materials used in their manufacturing businesses. The dividends are business income.

(D) Example D: A corporation is engaged in a multi-state heavy construction business. Much of its construction work is performed for agencies of the federal government and various state governments. Under state and federal laws applicable to contracts for these agencies, a contractor must have adequate bonding capacity, as measured by the ratio of its current assets (cash and marketable securities) to current liabilities. In order to maintain an adequate bonding capacity the corporation holds various stocks and interest-bearing securities. Both the interest income and any dividends received are business income.

(E) Example E: A corporation receives dividends from the stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the corporation. The dividends are business income.

(F) Example F: A corporation is engaged in a multi-state glass manufacturing business. It also holds a portfolio of stock and interest-bearing securities, the acquisition and

> holding of which are unrelated to the corporation's trade or business operations. The dividends and interest income received are non-business income.

86 Ill. Admin. Code § 100.3010(d). [2]

In each of the examples listed in subparagraphs (d)(5)(A) through (E) of this regulation, the stock holdings which give rise to business income, are themselves integral parts of the taxpayer's business operations. 86 Ill. Admin. Code § 100.3010(d)(5)(A) – (E). In example A, the dividend income is described as business income because the holder is engaged in the stock brokerage business, a business where acquiring and managing stock are regular, necessary, and therefore integral activities of a brokerage house. In example B, the dividends are business income because the holder acquires, manages and disposes of stock as a regular, short term profitable use of funds required to be available for operations attendant to the holder's business. *See* Allied Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 784 (1992) (all parties in Allied Signal conceded, and the United States Supreme Court agreed, that "short-term investment of working capital … is apportionable"). In example C, the dividends constitute business income because each taxpayer/ holder owns stock in a separate corporation in order to secure raw materials to be used in their separate business operations. In example D, the income is business income because the company owns stock as part of the reserves it is required to maintain for bonding purposes. Finally, in example E, the dividends are business income because the holder owns stock in another company that acts as the marketing agent for the holder's goods and/or services. In short, the applicable

[2] While 86 Ill. Admin. Code§ 100.3010(d)(5) addresses the classification of dividends as business or nonbusiness income, the U.S. Supreme Court has stated that the reasoning applicable to classifying dividends is equally applicable to the classification of gains from the sale of stock as business or non-business income. ASARCO Inc. v. Idaho Tax Commission, 458 U.S. 307, 330 (1982).

regulation's examples illustrate some of the different ways the stock giving rise to business income might constitute an essential part of the holder's "whole process of operating its business" (*see* Texaco-Cities, 182 Ill. 2d at 271). Conversely, the regulations also illustrate how the acts of acquiring, managing and disposing of stock might constitute a mere passive investment. 86 Ill. Admin. Code § 100.3010(d)(5)(F). Under these regulations, stock producing business income can be found to exist where this asset is used to support the taxpayer's business operations. If the stock is not used in this way, but is a passive investment, it does not produce business income. Accordingly, in applying the functional test, the issue presented is whether the taxpayer's 40% interest in "MTI" was integrally related to the taxpayer's business operations at the time it was sold in 1993.

The record which, with respect to the business income issue, consists almost entirely of stipulations and stipulation exhibits, indicates that prior to October 23, 1992, the taxpayer decided to completely divest its specialty minerals business in order to focus on its core health care business. Stip. ¶ 18. This decision was also based on the poor performance of the taxpayer's refractory operations, a component of the taxpayer's specialty chemicals business. Dep. of "Jean-Paul Sartre", pp. 85, 86. To effectuate this plan, the taxpayer entered into a written "Reorganization Agreement". Stip. Ex. 20. Pursuant to this agreement, the taxpayer transferred all of its assets related to its specialty chemicals business into "MTI". Dep. of "Jean-Paul Sartre", pp. 19, 20; Stip. Ex. 20. On October 22, 1992, the taxpayer sold 60 percent of its interest in "MTI" in an initial public offering. Mr. Sartre testified that after the spin off, "Puffnstuff" was engaged exclusively in the health care business, and had no involvement with the chemicals industry in which

"MTI" was engaged. Dep. of "Jean-Paul Sartre", pp. 59, 60, 61. Mr. Sartre also testified that the companies sold no raw materials, intermediate products or finished products to each other, (Dep. of "Jean-Paul Sartre", p. 21), and there is no evidence in the record that contradicts this testimony. Nor is there any evidence in the record that "Puffnstuff" exercised any control over "MTI" after the IPO. The deposition evidence in the record, which has not been refuted or contradicted by the Department, indicates that the taxpayer ceased to be involved in the day to day management of "MTI" or any of "MTI"'s decision-making processes. Dep. of "Jean-Paul Sartre", pp. 44, 45, 46, 53. Moreover, the record contains unrebutted evidence that the taxpayer played no role in financing "MTI" after the IPO. Dep. of "Jean-Paul Sartre", pp. 26, 27, 59. While the taxpayer's 1992 annual report records results for its specialty minerals division, there is no reference to this division as being one of the corporation's business segments in its 1993 annual report. All of this evidence is indicative of an intent to completely cease the taxpayer's specialty chemicals business after October, 1992.

In sum, the evidence, consisting primarily of the deposition testimony of "Jean-Paul Sartre", shows that after the initial public offering, the taxpayer ceased to exercise the control over "MTI"'s business essential to using this company as part of its operations, and "MTI" ceased to play any role in "Puffnstuff"'s business. The deposition of Mr. Sartre was not rebutted or contradicted by any evidence or testimony presented by the Department. Moreover, the Department presented no evidence in rebuttal to Mr. Sartre' testimony that might have revealed the existence of an operational purpose for continuing to hold stock in "MTI" after the IPO. Such evidence might have included documentary evidence showing the precise level of sales transactions between these

companies or evidence that these companies did not operate at arms length. Given the absence of any evidence presented by the Department to the contrary, it must be concluded that after the IPO, the taxpayer's stock in "MTI" was no longer the kind of property the taxpayer needed to conduct its business operations. In the absence of such evidence, I must conclude that the IPO marked the point at which this stock ceased to be an operational asset of "Puffnstuff". Consequently, I find that there is no evidence in the record to rebut documentary evidence and the testimony of Mr. "Sartre" that "Puffnstuff"'s stock in "MTI" was not integrally related to the taxpayer's regular business operations in any way after the IPO. Hence, the record does not support a finding of the required integral connection between the taxpayer's business operations and "Puffnstuff's" minority stock interest in "MTI" necessary to find that the income from the disposition of this stock constituted business income.

The record shows that some operational connections between "Puffnstuff" and "MTI" did remain after the IPO. After the IPO the taxpayer continued to provide payroll processing services, computer processing and data processing services and office space to "MTI" pursuant to a "Transitional Services Agreement" these entities entered into at the time of the IPO. Dep. of "Jean-Paul Sartre", pp. 30, 31, 33, 37; Stip. Ex. 17. However, the record also shows that these services were to be provided only temporarily until the taxpayer could make alternative arrangements. Dep. of "Jean-Paul Sartre", pp. 37, 39, 40, 41. The provision of transitional services on a temporary basis is hardly indicative of an intent to operate "MTI" as a segment of the taxpayer.

Other evidence showing operational relationships between "MTI" and "Puffnstuff" that might have been presented, including documents showing sales between

these companies after the IPO, was not brought out by the Department to rebut the deposition testimony that Mr. "Sartre" presented. Consequently, there is nothing in the record showing how "MTI" might have had a continuing operational function after the IPO.

The Department argues that the Illinois Supreme Court's holding in Texaco-Cities Service Pipeline, *supra*, requires a finding that the gain from the sale of the taxpayer's minority interest in "MTI" constituted business income. It contends that "(T)he central determination in Texaco-Cities was that the functional test is met if the capital asset that generates the gain 'was used by the taxpayer in its regular trade or business operations'." Dept. Brief p. 12. The record shows that, prior to the spin off, the assets that became part of "MTI" were used in the taxpayer's specialty chemicals business. Stip. ¶ 12. The taxpayer filed an Illinois Corporation Income and Replacement Tax Return, IL-1120, for 1992 that reported the income from the specialty chemicals business as apportionable business income. Stip. ¶25; Stip. Ex. 15. While these returns were subsequently amended, the taxpayer continued to report the income from its specialty chemicals business as business income. Stip. ¶ 25.

The Department's reliance upon Texaco-Cities is misplaced because the facts in Texaco-Cities are distinguishable from the facts at issue here. In Texaco-Cities the taxpayer was a pipeline company that sold off a portion of its tangible real and personal property consisting of pipeline assets and related real estate. The stock sold by "Puffnstuff" in this case was intangible property. Department of Revenue rules governing the classification of income from tangible property as business or non-business income do not apply to the classification of income from intangibles. Compare 86 Ill.

Admin. Code § 100.3010(d)(3) and 86 Ill. Admin. Code § 100.3010(d)(5). Moreover, the assets that were sold by Texaco-Cities Service Pipeline Co. were integral components of a business the taxpayer continued to engage in after this sale. These facts are distinguishable from the instant case where the assets that were sold were part of a business the taxpayer was no longer engaged in and were completely removed from the taxpayer's business activities for a discernible period of time prior to being sold. Consequently, the Texaco-Cities holding does not construe facts similar to the facts presented in this case.

The Department also argues that the functional test was met in this case because "the capital gain was from the sale of tangible property (converted into stock, an intangible property, six months before the sale) … acquired to expand "Puffnstuff's" research-based and customer oriented marketing" and was "managed in the same manner as its other corporate segments". Dept. Brief p. 10. While these assertions accurately reflect the relationship between "Puffnstuff" and its specialty chemicals business prior to the IPO, they do not accurately characterize this relationship after the spin off was completed or at the time "Puffnstuff" sold its minority interest in "MTI". The record shows that after the IPO "Puffnstuff" did not control "MTI", and that "MTI's" business ceased to be related to "Puffnstuff's" business in any way. Consequently, the previous relationships between the taxpayer and its specialty chemicals division are not sufficient to show that the "MTI" stock was integrally related to the taxpayer's ongoing business operations.

The Department also argues that "Puffnstuff's" gain on its sale of its minority interest in "MTI" constituted business income under the functional test because this stock

was sold “in order to restructure "Puffnstuff"’s market goals and generate capital to expand other research based segments of the company”. Dept. Brief p. 10. However, as pointed out by the U.S. Supreme Court in ASARCO v. Idaho State Tax Commission, 458 U.S. 307 (1982), one must assume that all corporate activities will be funded with the corporation’s available capital; all expenditures of a company’s capital “in some sense can be said to be ‘for purposes related to or contributing to the [corporation’s] business.’ ” ASARCO at 326. The court goes on to conclude that this “corporate purpose” test for determining when income can be classified as apportionable, “(W)hen pressed to its logical limit … becomes no limitation at all” on the state’s right to apportion income. *Id.* The U.S. Supreme Court again rejected the “corporate purpose” test in Allied Signal. Allied Signal, 788, 789. The Department’s illustrations in 86 Ill. Admin. Code § 100.3010(d)(5) distinguishing business and non-business income comport with the Supreme Court’s pronouncements. None of these illustrations indicate that the integral connection between stock and the operations of the taxpayer’s business needed to support a finding that income from such stock is business income, can be supplied merely by showing that the proceeds from the sale of the stock were used in the taxpayer’s ongoing business operations.

In sum, after considering all of the facts revealed by the record, for the reasons noted above, I conclude that the taxpayer has rebutted the Department’s prima facie determination that the income at issue here should have been reported as business income. Since the evidence shows that "Puffnstuff" did not purchase, manage or dispose of its minority interest in "MTI" as part of its regular business operations, these gains do not constitute business income under the transactional test. Moreover, because the

Department failed to present any evidence to rebut the deposition testimony of Mr. "Sartre", and other evidence produced to support the taxpayer's claims, the unrebutted and uncontradicted evidence in the record shows that the taxpayer's acquisition, management and disposition of this stock was not integrally related to its business operations at the time this stock was sold. Based on the record before me, consisting largely of the uncontradicted and unrebutted deposition testimony of Mr. "Sartre", I am compelled to conclude that after the IPO, the taxpayer's minority stockholding in "MTI" was essentially a passive investment. Consequently, I conclude that the gain from the sale of this investment did not constitute business income under the functional test.

The Department also cites cases applying the so-called "step transaction" doctrine and argues that the analysis contained in these cases should be applied in determining whether the functional test has been met. Department Brief pp. 14 – 18. The step transaction doctrine is a rule that the Federal courts have adopted to deal with cases that are governed by the Internal Revenue Code. B. Bittker and J. Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 1.05 at p. 1-16 (5th ed. 1987). The Department has cited no authority for applying Federal income tax rules and principles for determining the scope of section 1501(a)(1). The Illinois appellate court has held that the IITA incorporates federal income tax concepts. Bodine Elec. Co. v. Allphin, 70 Ill. App. 3d 844 (1st Dist. 1979). However, this rule of statutory construction is applicable only where federal income tax terms and concepts being applied in Illinois are used in a "comparable context" in the IRC. 35 **ILCS** 5/102. The federal income tax law contains nothing comparable to "business income" as defined in section 1501(a)(1).

Consequently, rules of statutory construction cannot be cited as authority for applying the federal income tax "step transaction" concept in this case. [3]

Moreover, even if it could be shown that the application of a step transaction analysis is appropriate here, the facts do not support a finding that the functional test can be met through the application of this doctrine. In Greene v. United States, 13 F. 3d 577 (2d Cir. 1994), the court describes the step transaction doctrine as follows:

> The [step transaction] doctrine treats the 'steps' in a series of formally separate but related transactions involving the transfer of property as a single transaction, if all the steps are substantially linked … Rather than viewing each step as an isolated incident, the steps are viewed together as components of an overall plan … Of course, the doctrine cannot manufacture facts that never occurred … Under the end result test, the step transaction doctrine will be invoked if it appears that a series of separate transactions were prearranged parts of what was a single transaction, cast from the outset to achieve the ultimate result … The interdependence test is a variation of the end result test … It focuses on whether the steps are 'so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series … To apply this test, a court must determine whether the individual steps had 'independent significance or whether they had meaning only as part of the larger transaction.'
>
> Greene at 583, 584.

The Department argues that two separate transactions, "Puffnstuff's" sale of its majority interest in "MTI" in 1992, and its subsequent sale of its minority interest in 1993 should be treated as being in substance a single transaction. Dept. Brief p. 14. However, this argument ignores the fact that the two transactions that the Department seeks to treat as a single event were not components of a single transaction. Neither of the transactions the Department seeks to treat as a single event were dependent upon the carrying out of

[3] While the Department, at p. 15 of its brief, cites 86 Ill. Admin. Code, section 100.3010(d)(3) as authority for applying the step transaction doctrine in this case, this regulation makes no reference to this doctrine or to any other interpretation of the Internal Revenue Code.

the other. Although the taxpayer initially contemplated the disposition of all of its "Puffnstuff" stock at one time, market conditions made such a sale impossible. Dep. of "Jean-Paul Sartre", pp. 65, 66, 67, 68, 69. Consequently, the taxpayer sold only 60% of its "MTI" stock as part of this company's IPO. This transaction was in no way contingent upon the subsequent sale of its minority interest. While, as noted at pages 16 and 17 of the Department's brief, the taxpayer did agree not to sell additional shares for 180 days following the IPO, this does not show that the taxpayer planned to sell its minority interest in "MTI" six months after the IPO, as the Department claims. Department Brief p. 17. The timing of the taxpayer's sale of its minority interest in "MTI" was not part of a preconceived plan; the timing of this sale was dictated solely by market conditions and the taxpayer's desire to obtain a fair price for this stock. Dep. of "Jean-Paul Sartre", p. 73. Had the taxpayer's sale of its minority interest never taken place, due to market conditions, the taxpayer's IPO would have in no way been affected. Given these facts, neither the "end result" test nor the "interdependence test" for applying the step transaction doctrine was satisfied here.

Due Process and Commerce Clause Issue

The conclusion that the gain on the taxpayer's sale of 40% of "MTI" stock was non-business income is also dictated by constitutional limitations on non-domicilliary states' taxing authority.[4] As a general principle, a state may not tax value earned outside its borders. ASARCO Inc., *supra*. In order to do so, it must establish "some definite link … some minimum connection, between a state and the person, property or transaction it seeks to tax." Allied Signal at 777, quoting Miller Brothers Co. v. Maryland, 347 U.S.

[4] "Puffnstuff" is a Delaware corporation and has its principal place of business in New York; it is not domiciled in Illinois. Stip. Ex. 20, 22.

340, 344, 345 (1954); Hercules, Inc. v. Dept. of Revenue, 753 N.E. 2d 418, 424 (1st Dist. 2001), citing Quill Corp. v. North Dakota, 504 U.S. 298, 306 (1992). The existence of a unitary relationship between a taxpayer realizing a capital gain and the entity whose stock was sold is one means of meeting this constitutional requirement for taxing income by apportionment. Allied Signal, at 785; Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425, 439 (1980) ("[T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle").

In this case, the taxpayer argues that the Department cannot meet the constitutional prerequisites required to apportion "Puffnstuff's" gain from the sale of "MTI" by showing that "Puffnstuff" and "MTI" were engaged in a unitary business at the time "Puffnstuff" sold its 40% interest in "MTI". Taxpayer Brief pp. 8, 9, 10. The Illinois Income Tax Act prescribes the criteria to be applied in determining whether a unitary business exists at 35 **ILCS** 5/1501(a)(27) which provides in pertinent part as follows:

> The term "unitary business group" means a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other … Common ownership in the case of corporations is the direct or indirect control or ownership of more than 50% of the outstanding voting stock of the persons carrying on unitary business activity.
> 35 **ILCS** 5/1501(a)(27)

The U.S. Supreme Court has also prescribed criteria for making this determination, stating that indicia of a unitary business are functional integration, centralization of management and economies of scale. Allied-Signal, 504 U.S. at 789. Functional integration can be established by showing that there are transfers of products between companies in the same or a similar business. Exxon Corp. v. Wisconsin, 447 U.S. 207,

224, 225 (1980). Economies of scale have been found to exist where two enterprises can combine their resources to produce a less expensive product. Citizens Utilities Co. of Illinois v. Department of Revenue, 111 Ill. 2d 32 (1986). Centralization of management is found where a single cadre of officers and directors control the operations of a related group of companies. *Id*. Evidence of centralized management is found where affiliated corporations share the same officers and have interlocking boards of directors. *Id*; Hormel Foods Corp. and Jennie-O-Food, Inc. v. Zehnder, 316 Ill. App. 3d 1200, 1210 (1st Dist. 2000).[5] The taxpayer contends that neither the test set forth in section 1501(a)(27) of the IITA nor the test set forth in Allied Signal has been met in this case.

The record supports a finding that the taxpayer and "MTI" were not engaged in a unitary business under the test set forth in section 1501(a)(27) of the IITA at the time the taxpayer sold its minority interest in "MTI". The record shows that the taxpayer held a minority interest in "MTI" which it liquidated. As noted in Hercules, Incorporated , *supra*, "Illinois law requires that in order for a subsidiary to be a member of a unitary business group with its parent, the parent corporation must control or own more than 50% of the stock of the subsidiary". *Id* at 425.

With respect to centralization of management, Mr. "Sartre" testified that "MTI" had its own Board of Directors that independently ran the company. Dep. of "Jean-Paul Sartre", pp. 53, 54. Moreover, he testified that "MTI's" management made its own operational decisions and set its own policies. Dep. of "Jean-Paul Sartre", pp. 48, 52, 53. He also testified that "MTI"'s management independently arranged the company's

[5] The Illinois appellate court has rejected the notion that functional integration is a separate concept from centralized management and held that "whenever there is functional integration of operations there is also strong centralized management and vice versa." A.B. Dick Co. v. McGaw, 287 Ill. App. 3d 230, 233 (1997).

financing. Dep. of "Jean-Paul Sartre", p. 27. According to Mr. "Sartre", "MTI's" management did not report to "Puffnstuff's" management after the IPO. Dep. of "Jean-Paul Sartre", pp. 45, 46. This evidence, which the Department did not rebut or even contest, is indicative of a lack of centralization of management for purposes of applying the Allied Signal test for determining whether a unitary business exists.

The record shows that "Puffnstuff" did have two directors on the "MTI" board after the spin-off of "MTI". Dep. of "Jean-Paul Sartre", p. 53. In addition, "MTI" had a director on the "Puffnstuff" Board. Dep. of "Jean-Paul Sartre", p. 54. However, the Supreme Court has held that having some common directors is not enough to establish centralization of management. In Allied-Signal, the court concluded that there "was no centralization of management" even though Allied-Signal's CEO and one of its directors had seats on the board of a company it sold. Allied-Signal at 775, 778.

The record also supports a finding that "Puffnstuff" and "MTI" did not remain functionally integrated after the spin off of "MTI". This is true primarily because after 1992, "Puffnstuff" and "MTI" were engaged in separate businesses. Mr. "Sartre" testified that "Puffnstuff" was engaged exclusively in the health care business, and had no involvement in the chemicals industry, (Dep. of "Jean-Paul Sartre", pp. 59, 60, 61), while "MTI" was engaged in the business of developing and producing mineral, mineral based, and synthetic mineral products for the paper, steel, polymer, and other manufacturing industries. Dep. of "Jean-Paul Sartre" , pp. 6, 7. He also testified that the companies sold no raw materials, intermediate products or finished products to each other. Dep. of "Jean-Paul Sartre", p. 26. As noted earlier, the Department produced no

documents or other evidence showing the level of sales between these companies after the IPO to refute Mr. "Sartre's" testimony.

With respect to economies of scale, the record shows that after the spin off of "MTI", the companies had entirely separate manufacturing, distribution and research facilities. Stip. ¶ 14, 15, 16; Dep. of "Jean-Paul Sartre", pp. 20, 21. Mr. "Sartre" testified that they pooled no technical facilities and had no common raw materials or product lines. Dep. of "Jean-Paul Sartre", pp. 8, 21. He testified that each company had its own legal staff, auditors and other employees. Dep. of "Jean-Paul Sartre", pp. 24, 25, 31, 32, 33, 34, 35. He also stated that the companies had no common marketing promotions and shared no common trademarks or logos. Dep. of "Jean-Paul Sartre", pp. 35, 36, 43. The companies had separate banking relationships, separate financial statements and separate annual reports. Dep. of "Jean-Paul Sartre", pp. 25, 26, 52, 53. Consequently, the record, much of which consists of the uncontradicted and unrebutted testimony of Mr. "Sartre", does not support a finding that any "Puffnstuff" or "MTI" products were produced at lower cost by combining the resources of the two companies, or that there were any other economies of scale.

Unquestionably, if "Puffnstuff" had sold its entire interest in "MTI" in 1992, there would have been no constitutional impediment to the taxation of "Puffnstuff's" gain under the unitary concept as "Puffnstuff" owned more than 50% of the taxpayer's stock up to that time. However, the crux of the taxpayer's argument is that after 1992, when it sold 60% of "MTI" in an IPO, the taxpayer and "MTI" ceased to be unitary, and the taxpayer's business no longer had anything to do with "MTI's" manufacture of chemicals. As indicated above, the record in this case fully supports these contentions. It

shows that, after the spin off, the taxpayer no longer had any facilities, personnel or technology to engage in the business of manufacturing or marketing chemicals. Moreover, when "Puffnstuff" divested itself of "MTI" it no longer owned a majority interest in the company or exercised any control over the policies or day to day operations of its former subsidiary. Accordingly, I find that the taxpayer and "MTI" were not engaged in a unitary business at the time of its sale of its 40% interest in this company.

While a showing of a unitary relationship between "Puffnstuff" and "MTI" is one way of meeting the constitutional requirements for Illinois to tax "Puffnstuff's" capital gain by apportionment, it is not the only means. Allied Signal, at 787. If the evidence shows that the "MTI" stock "Puffnstuff" held served an operational rather than an investment function, then the income can properly be apportioned and taxed by Illinois, even if "Puffnstuff" and "MTI" were not engaged in the same unitary business. *Id*.

In Allied-Signal, the Supreme Court explained that a stock investment would be an "operational" asset if it "amounted to a short-term investment of working capital analogous to a bank account or certificate of deposit". Allied-Signal, at 790. The record in this case indicates that the taxpayer's interest in "MTI" stock was not a short-term investment of working capital analogous to a bank account or certificate of deposit. The taxpayer's investment in "MTI" dated from 1968 when this company was organized. Stip. Ex. 22. As a result of the reorganization of the taxpayer's specialty chemicals business in 1992, "MTI" acquired all of the assets of the taxpayer's specialty chemicals business. Dep. of "Jean-Paul Sartre", pp. 19, 20. However, there is no evidence in the record that the reorganization altered the long term nature of the taxpayer's "MTI"

holding. Moreover, "Puffnstuff's" 40% interest in "MTI", which it retained after the IPO, was a continuation of this long term investment. Given these facts, it is difficult to consider "Puffnstuff's" long term investment in "MTI" stock analogous to any type of short term banking investment.

The conclusion that "Puffnstuff's" minority investment in "MTI" was not analogous to a short term CD or bank account is supported by the reasoning in Hercules, Inc., *supra*. The issue in this case was whether gains Hercules recognized on the sale of a minority interest in the stock of a supplier company constituted business income. The appellate court ruled that this gain could not properly be characterized as apportionable business income under the U.S. Supreme Court's ruling in Allied Signal. In reaching this conclusion, the court addressed the issue of whether the taxpayer's investment was analogous to a short term investment of working capital in a CD or bank account. The court concluded that Hercules' investment in the minority stock of its supplier was not analogous to a short term banking investment because there was no evidence that Hercules used its investment in its supplier as a repository for working capital or as a ready source of working capital. The record in this case is similarly devoid on any such evidence.

Additional evidence that "Puffnstuff's" investment in "MTI" was not analgous to a short term investment in a CD or bank account is found in the minutes of the "Puffnstuff" Board. The October 22, 1992 minutes (Stip. Ex. 21) disclose that the decision to retain a minority interest in the "MTI" stock was an investment and not simply an interim use of idle funds:

> Mr. "Sartre" left the Meeting and Messrs. "T. Savales" and "M. Valdemar" of "Puffnstuff", "H.R. Block", Esq. of "Dewey, Cheatum &

> Howe" and Messrs. "G. Meir", "M. Jackson" and "L. Hampton" of "Winken, Blinken & Nod". entered the Meeting. Dr. "Morris" advised the Board that since its last consideration of the "MTI" initial public offering the managing underwriters had advised him that due to weakening market conditions and other factors a majority of the outstanding shares could not be sold at the minimum price of $18 per share set by the Board. Dr. "Morris" reviewed the situation and compared a sale of a majority of the outstanding shares at $16 per share with other alternatives, including retaining 100% of the business. He noted that for both financial reasons as well as considerations of morale of the employees in this business and the commitment of management time to it that would be required he would recommend that the Board grant authority to the Pricing Committee to agree to the sale of a majority of the "MTI" shares at a minimum price of $16 per share or at least 60% of the "MTI" shares at a minimum price of $15.50 per share. … they discussed the fact that a substantial minority of the shares are being retained which provides the Company with the possibility of appreciation in value should the business continue to grow and prosper. (emphasis added)

The investment nature of the transaction is confirmed by the stated intention of the taxpayer at the time of the initial public offering to hold the stock until it appreciated. Dep. of "Jean-Paul Sartre", pp. 65, 66, 67, 68, 69.

In Allied-Signal , at 788, the court indicated that an operational function can also be found where stock of a company is acquired to assure a supply of raw materials for a manufacturing concern or as a hedge against price inflation. See Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955) (futures transactions found to be an integral part of taxpayer's business where they were designed to protect its manufacturing operations against a price increase in its principal raw material and assure a ready supply). "Puffnstuff's" investment in "MTI" clearly did not exist to provide the taxpayer with a supply of raw materials. After the IPO, "MTI's" sales to the taxpayer were *de minimis*. Dep. of "Jean-Paul Sartre", p. 29. Moreover, the taxpayer's decision to create "MTI" and continue to hold an investment in this company after the IPO had nothing to

do with "Puffnstuff's" ongoing business operations. Dep. of "Jean-Paul Sartre", pp. 60, 61, 62, 63, 64, 65, 66, 67, 68, 69, 72, 77.

In sum, the record in this case supports a finding that "Puffnstuff" and "MTI" were not engaged in a unitary business. Moreover, the record indicates that "Puffnstuff's" minority interest in "MTI" was held for an "investment" rather than an "operational" purpose. Accordingly, I conclude that the Department has not met the constitutional requirements for taxing "Puffnstuff's" income by apportionment.

The Reseach and Development Credit Issue

This matter involves the disallowance of Illinois research and development credits provided for under Section 201(k) of the Illinois Income Tax Act, 35 **ILCS** 5/201(k). The taxpayer claimed these credits on its original income tax returns for the years 1993 and 1994. The Department issued a Notice of Deficiency denying the taxpayer's 1993 claim and denied the research and development credit claimed on the taxpayer's amended return (form 1120-X) for 1994. [6]

The Department established the prima facie correctness of its determinations when it introduced the Notice of Deficiency and the Notice of Denial into evidence. Stip. Ex. 1, 3, 7, 11; 35 **ILCS** 5/904; 35 **ILCS** 5/910. Thereafter, the burden shifted to the taxpayer to prove that the Department's determination was in error. 35 **ILCS** 5/904(a); Balla v. Department of Revenue, 96 Ill. App. 3d 293, 295 (1st Dist. 1981). A taxpayer's testimony alone will not overcome the Department's prima facie case. Jefferson Ice. Co. v. Johnson, 139 Ill. App. 3d 626, 632 (1st Dist. 1985); Central Furniture Mart v. Johnson, 157 Ill. App. 3d 907 (1st Dist. 1987). To overcome the Department's prima facie case,

[6] The Department initially issued a Notice of Overassessment allowing the taxpayer's R&D credit for 1994 on January 26, 1999, but subsequently advised that this credit was incorrectly permitted.

the taxpayer must present consistent and probable evidence identified with books and records. *Id*.

Section 201(k) of the IITA, 35 **ILCS** 201(k), provides for a credit against the regular income tax for increasing research activities in Illinois. The credit equals 6 ½% of "qualifying expenditures" for increasing research activities in the state. "Qualifying expenditures" means qualifying expenditures as defined for purposes of the Internal Revenue Code ("IRC") § 41, 26 U.S.C.A. § 41, incurred for activities that are conducted in Illinois. Qualifying expenditures for increasing research activities in the state will be deemed to exist where qualifying expenditures for the tax year exceed qualifying expenditures for the "base period". The "base period" is the three years immediately preceding the tax year for which the credit is calculated. 35 **ILCS** 5/201(k); 86 Ill. Admin. Code § 100.2160(d); 86 Ill. Admin. Code § 100.2160(e).

Section 41 of the IRC provides for a nonrefundable credit for incremental research expenses paid or incurred in a trade or business. IRC § 41(b) defines "qualifying research expenses" as the sum of in-house expenses and contract research expenses paid or incurred by the taxpayer during the taxable year in carrying on a trade or business of the taxpayer.[7] Qualifying expenditures also includes basic research payments, as that term is defined in IRC § 41(e). 86 Ill. Admin. Code § 100.2160(c).

The taxpayer contends that it increased "qualifying research expenditures" in Illinois as required by 35 **ILCS** 5/201(k), and therefore met all of the criteria necessary to qualify for the Illinois R&D credit. Taxpayer Brief pp. 11, 12. The taxpayer measured this increase in research activities by comparing expenditures during the "base period" for 1993 (1990, 1991, 1992) and for 1994 (1991, 1992, 1993) with "qualifying research

expenditures" in 1993 and 1994, respectively. Tr. p. 22; Stip. Ex. 25, 26. At the hearing, the taxpayer produced a schedule indicating the amount of contract research expenses in these years that showed a steady increase in these expenses between 1990 and 1994. Stip. Ex. 31. The taxpayer used this schedule to compute its Illinois R&D credit. Tr. p. 22. The taxpayer contends that this schedule, and the sources used to prepare it, adequately document the R&D credits it claimed.

The taxpayer's R&D credits fall into two categories: 1) R&D credits based on qualifying expenses for contract research incurred by its Connecticut research facility (hereinafter the "Connecticut R&D credit"); and 2) R&D credits based on qualifying expenses for contract research incurred by its U.S. Pharmaceutical Group (hereinafter the "USPharm R&D credit"). Tr. pp. 17, 18, 19. The taxpayer contends that it has submitted enough documentation to qualify for the Illinois R&D credit for both of these categories. Taxpayer Brief pp. 11, 12. After the hearing in this case, the Department agreed that the taxpayer provided enough documentation to support its Connecticut R&D credit. Department Brief p. 27. Hence, the only remaining issue is whether the US Pharmaceutical R&D credit is adequately supported by documentation contained in the record.

The only witness called to testify at the hearing was Mr. "Benjamin Braddock". Mr. "Braddock" is currently the taxpayer's state tax counsel. Tr. p. 14. However, his position with "Puffnstuff" during the tax period in controversy was not indicated during the hearing proceedings.

Mr. "Braddock" testified extensively regarding the manner in which the Connecticut and US Pharmaceutical R&D credits were prepared. His testimony with

[7] The federal tax credit is available for 65% of contract research expenses. IRC §41(b)(3).

respect to the Connecticut R&D credit was corroborated by excerpts from detail used to prepare accounts payable ledger account 2180 and 2190. Stip. Ex. 29, 30. As noted above, the Department now agrees that these records are enough to support the taxpayer's claim.

The taxpayer also contends that it has produced sufficient documentation to support its US Pharmaceutical R&D credit. Taxpayer Brief pp. 11, 12. However, unlike the Connecticut R&D credit, the data used to compute the amount of expenditures qualifying for the US Pharmaceutical R&D credit were not taken from the taxpayer's detail used to prepare its accounts payable ledger account or from other financial books and records. Tr. pp. 21, 29, 30. While Mr. "Braddock" testified that the amounts shown on Ex. 31 reflected US Pharmaceutical expenditures for R&D conducted in Illinois, he readily admitted that there are no existing documents to support this claim. Tr. p. 40. Moreover, the taxpayer has presented no evidence of any kind to show that the US Pharmaceutical expenditures were "qualified expenditures" under § 41 of the IRC.

To overcome the Department's prima facie case, a taxpayer must present consistent and probable evidence identified with its books and records. Central Furniture Mart, *supra*. Moreover, because the credit claimed by the taxpayer can be applied to reduce the taxpayer's Illinois income tax liability in the same manner as an exemption, the taxpayer must also show that it clearly comes within 35 **ILCS** 5/201(k). United Airlines v. J. Thomas Johnson, 84 Ill. 2d 446 (1981). A taxpayer's testimony alone will not overcome the Department's prima facie case. Central Furniture Mart, *supra*. The record in this case clearly establishes that the taxpayer was engaged in extensive research and development activities. Stip. Ex. 17, 18. However, the only evidence in the record

regarding the nature and location of the US Pharmaceutical R&D expenditures the taxpayer claims qualified under 35 **ILCS** 5/201(k) is Mr. "Braddock's" testimony. This testimony is insufficient to rebut the Department's prima facie case. *Id*.

In support of the taxpayer's claims regarding the US Pharmaceutical R&D credit, Mr. "Braddock's" testified that the financial data used to determine this credit is reliably reflected in Ex. 31. Tr. p. 21. Although the Department did not object to Mr. "Braddock's" testimony, there is no evidence in the record to indicate that he was competent to give this opinion. Indeed, the record suggests that Mr. "Braddock" may not have been an employee of the taxpayer at the time the decision was made to destroy the financial records allegedly used to prepare the US Pharmaceutical R&D credit. Tr. p. 41.

For the reasons set forth, I find that the record in this case does not support a finding that the taxpayer's US Pharmaceutical Group expenses were for qualified research or for research and development performed in Illinois during 1993 and 1994. Accordingly, I find that the taxpayer has failed to rebut the Department's prima facie case or meet the additional burden of proving that it clearly met the criteria for taking the Illinois R&D credit under 35 **ILCS** 5/201(k). Therefore, I find that the Department properly refused to allow the US Pharmaceutical R&D credit taken by the taxpayer on its 1993 and 1994 Illinois income tax returns.

Conclusion

As noted above, the Department concedes that the taxpayer is entitled to a capital loss carryback for the tax year ending 12/31/95 that originated in the tax year 12/31/97. Moreover, the Department concedes that the taxpayer is entitled to the portion of the

research and development credits for 1993 and 1994 attributable to the taxpayer's Connecticut research facility.

WHEREFORE, for the reasons stated above, it is my recommendation that the NODs issued for 1993 and the Notices of Denial issued for 1994 and 1995 be modified: 1) to cancel the assessment on the taxpayer's capital gain; 2) to allow a research and development credit for research and development expenditures by the taxpayer's Connecticut facility; and 3) to allow a carryback for the tax year ending 12/31/95 that originated in the tax year ending 12/31/97 and, as so adjusted, be made final.

Ted Sherrod
Administrative Law Judge

Date: October 5, 2001